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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 93-215
	)	
Rate Regulation	)	

COMMENTS OF AUSTIN, TEXAS; KING COUNTY, WASHINGTON; AND MONTGOMERY COUNTY, MARYLAND

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Summary

(1) The City of Austin, Texas; King County, Washington; and Montgomery County, Maryland ("Local Government Coalition") are submitting comments in the above docket.

(2) The Local Government Coalition urges the Federal Communications Commission to establish cost of service rules that carry out Congress' intent to eliminate monopoly profits from cable rates. The Commission should establish rules that ensure that cable rates are not permitted to remain at current, unreasonable levels, or even increase.

(3) The Commission's cost of service rules should make sure that all revenues and cost savings, as well as all expenses, are reflected in the cable operator's allowable rate.

(4) The rules should not permit operators to recover for expenses that outweigh the benefits received by subscribers as a result of those expenses. Similarly, the Commission properly

proposes to exclude acquisition costs and intangibles from rate base.

(5) The Commission should establish rules that do not permit cost shifting or gaming as a means to avoid effective regulation. For example, charges imposed by corporate parents should generally not be allowed as a recoverable expense. Likewise, partial or "streamlined" cost of service showings should not be allowed, for large or small systems. The rules also should not draw a strict wall between regulated and unregulated services and equipment revenues.

(6) The Commission should design rules that recognize and account for the realities of the cable industry. For example, the rules should acknowledge that the industry is heavily leveraged. In addition, an operator showing a paper loss may nevertheless be financially healthy and profitable.

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In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 Rate Regulation	))))))))	MM Docket No. 93-215

COMMENTS OF AUSTIN, TEXAS; KING COUNTY, WASHINGTON; AND MONTGOMERY COUNTY, MARYLAND

This filing is submitted on behalf of the City of Austin, Texas; King County, Washington; and Montgomery County, Maryland ("Local Government Coalition"), all of whom plan to regulate rates of the cable companies within their respective jurisdictions.

The Local Government Coalition is submitting this initial filing to identify principles that should guide the FCC in making decisions regarding key issues in this docket. There is a real risk that, unless the FCC establishes a cost of service method designed to eliminate monopoly rents from prices for regulated services and equipment, rates will increase and not decrease. Indeed, as the Commission is aware, operators are already claiming that the FCC's benchmarks are forcing them to raise rates for regulated services, and that the cost of service option will allow operators to keep rates at current high levels (or even raise them further). It is important that the FCC establish standards that make it clear it is not creating an escape hatch from effective regulation.

I. GENERAL COST OF SERVICE PRINCIPLES

The NPRM in this proceeding identifies several principles that underlie the FCC's proposed rules. Most of those principles are sound, but they are not, by themselves, sufficient.

The FCC has correctly chosen to adopt a plan under which (a) authority to file would be limited; and (b) an operator would have an opportunity (but not a guaranteed right) to earn a reasonable return on its prudent investments used and useful in providing regulated services.

However, the FCC's rules also should reflect at least four other principles.

First, any rules the FCC adopts should follow a "matching principle" -- that is, where an operator is allowed to recover an expense through regulated rates, all corresponding benefits associated with that expense, and all factors that reduce the size of that expense, must also be taken into account.[1] For example, if the FCC allows a return on a post-tax basis -- and hence recognizes taxes as an expense -- it must also recognize all tax benefits received by operators, and those benefits must be reflected in subscriber rates.

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[1] The statute itself limits operators to recovering costs reasonably allocable to regulated services, and requires recognition of offsetting revenues. Cable Television and Consumer Protection Act of 1992, 47 U.S.C. § 543(b)(2) and (c)(2).

Second, no investment should be recognized for purposes of establishing regulated rates unless the benefits to subscribers to the regulated services that are associated with the investment outweigh the costs associated with the investment. Under this principle, for example, one would not recognize any price paid above depreciated book value for an asset unless the buyer could clearly show that the additional amount paid was at least equal to savings passed on to consumers in regulated rates.[2]

Third, the regulatory system should not give operators an opportunity to "pick and choose" regulatory rules in order to obtain the most favorable results. Otherwise, operators will be able to game the FCC's system to further increase rates.

Fourth, the regulatory system should ensure that rates are stable over time. That may require the Commission to devise a system that recognizes that the typical pattern in the industry is to show lower apparent profits or paper losses in the initial years of a franchise, and higher profits in later years. In addition, it may require the Commission to focus more closely on cash flow and not upon traditional rate of return in measuring the health of the industry and of particular companies.

At least one principle proposed by the NPRM may be questionable: the decision to provide a return on a post-tax basis. The Local Government Coalition recognizes that

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[2] Such savings might be seen if, for example, operating costs such as administrative and general expenses were reduced on a per customer basis as a result of the consolidation of two systems.

traditional utility regulation is designed to provide a return on a post-tax basis. However, the Commission should recognize that the effective tax rates for cable systems may be far below the ostensible statutory rates. For example, while TCI's book statements show income tax expenses in certain years, TCI has paid very little federal income tax over the last four years.[3] In addition, cable operators subject to regulation include corporations, partnerships and cooperatives, each of which is subject to varying tax treatment. There is some danger that the Commission's approach will favor one organizational form over another (as well as complicating accounting). Therefore, the Commission should carefully consider whether it is necessary or appropriate to regulate on a post-tax basis to fully protect subscribers.

One principle proposed by the Commission requires reconsideration: that is the decision to draw a strict wall between regulated service and equipment expenses and revenues and unregulated equipment and service revenues.

As the members of the Local Government Coalition have urged throughout the FCC's rate rulemaking, the Commission can best ensure that the benchmarks are adequate and that cost of service filings are not filed frivolously by taking two steps. First, the current benchmarks should be replaced ultimately by cost-based benchmarks. Second, in order to obtain any cost of service

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[3] See Tele-Communications, Inc., 1992 Annual Report 34, 38 (1992).

relief, an operator should be required, as a first step, to show that the rates for regulated services are so low that it has no opportunity to earn a reasonable return on the system. Thus, any cost of service proceeding would begin by examining revenues from all sources, not just from regulated services. Particularly given the allocation problems noted below, this approach protects against cross-subsidization that could discourage the development of competitive telecommunications systems.

II. REVENUE REQUIREMENT ISSUES

A. Operating Expenditures

1. The FCC Must Carefully Circumscribe the Ability of Operators to Include Parent Company Costs in Rates.

The FCC proposes to allow operators to recover parent company costs in rates through cost of service proceedings. But, in the case of most MSO-operated systems, the entity that owns the system serving a particular franchise area is merely the last in a long line of interrelated corporations, partnerships and holding companies which are engaged in a series of transactions with one another.[4] Many costs charged to the local systems are mechanisms primarily designed to move funds from subsidiaries to parents. Often, for example, a "management fee" is paid to

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[4] In Jefferson County, Kentucky, for example, the local system was owned by Storer Jefferson, the stock of which in turn was owned indirectly by TKR-Storer Limited Partnership, the general partner of which was TCI Storer, Inc., and the limited partner of which was SCI Partners, a general partnership owned partly by Country Cable Company, which in turn was a subsidiary of Liberty Media. TCI Storer was in turn owned by TCI, Inc.

the parent company that is not limited to recovering actual costs associated with providing services to subsidiaries. There is thus a real risk that corporate operational could be inflated in ways that will be difficult to trace, much less correct.

The Commission therefore should carefully consider whether it should recognize <u>any</u> parent costs that are not directly attributable to unique services received by a local company[5] or revenues recognized at the local level[6]. In any event, the FCC must carefully avoid the double-counting that could occur if both management fees paid by local companies to parents <u>and</u> the parent's costs were separately recognized. Corporate charges primarily designed to transfer profits to the parent company should not be permitted under any circumstances, as such transfers would allow the company to earn more than the prescribed rate of return on investment. Finally, if the FCC allows any recognition of corporate parent costs, it must make clear that the entities whose costs the local operating company seeks to recover must open their books both to the Commission and to franchising authorities.[7] Traditionally, the industry has

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[5] The cost of programming sold to the local operating company would be such a cost.

[6] Such costs might be incurred if a regional subsidiary sells advertising for a number of systems.

[7] The Coalition strongly supports the FCC's tentative decision to closely scrutinize intra-corporate transactions. It is particularly important that the Commission disallow parent company mark-ups of programming costs for programming supplied to subsidiaries, and that the Commission monitor the price at which programming subsidiaries sell to the parent corporation.

been reluctant to open parent company books for inspection by local franchising authorities.

2. The FCC Should Not Treat Programming Expenses Differently From Other Expenses.

The FCC asks whether it must allow operators to capitalize programming expenses, and earn a return on programming investment in order to give operators an incentive to provide adequate service. Such a "cost plus" method would create perverse incentives to add programming regardless of customer demand. Moreover, the "cost plus" approach would create additional opportunities for gaming the regulatory system unless the Commission plans to require operators to carry the specific programming claimed for capital expense treatment.[8]

B. Rate Base

As proposed by the FCC, rate base would have three components: (1) plant in service; (2) plant held for future use; and (3) working capital. The FCC's proposed approach to rate base is to recognize only the plant that is used and useful to recipients of regulated services and that represents a prudent investment; and to recognize only the original cost of such plant, plus additions and less depreciation. This approach is basically sound, although, as noted in parts B. 2-4, some aspects of the FCC's approach require clarification.

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[8] Indeed, it may be wise for the FCC to require operators to regularly adjust rates so that subscribers are not charged more than the actual cost paid for programming during a particular year.

1. The Commission has Properly Decided to Exclude Acquisition Costs and Other Intangibles From Rate Base.

The FCC has correctly decided to exclude what it calls "excess acquisition costs" and intangible values from rate base. This is in keeping with general principles of utility regulation, and is necessary to prevent operators from collecting monopoly rents. Indeed, in 1990, TCI obtained significant tax benefits for itself and other cable industry members by convincing the courts that cable systems have no "good will" and that a substantial part of the price paid for systems

> stems from the prospect it offers to earn supernormal profits...[T]he value of a franchise is the (capitalized) value of the supernormal returns expected from the franchised activity -- the income over and above what would provide the investor with a competitive return for the risk involved..."

"The Value of Three Cable TV Franchises," paper submitted by William B. Shew for Tele-Communications, Inc. in Tele-Communications, Inc. v. Commissioner of Internal Revenue, 95 T.C. No. 36 (1990)("Shew Report"). Hence, allowing operators to recognize such intangibles in any form -- whether in rate base or by amortizing excess acquisition costs over time -- necessarily would allow the operator to recover amounts in excess of the rate that would be charged in a competitive market, and would therefore be inconsistent with Congress' mandate.

For similar reasons, the Commission is correct in its tentative conclusion that losses ought not to be recognized in the rate base. First, the losses themselves may largely reflect depreciation of assets valued in a manner that includes excess acquisition costs. Second, the Commission will have no way to ensure that the losses have not already been recovered through prices charged in the unregulated past. (An ostensible loss in one prior year may well be offset by years of banner profits.) But in any event, losses cannot be an asset "used and useful" to today's subscribers except to the extent the losses are carried forward as an offset against other revenue requirements.

2. The Commission Must Also Scrutinize Any Effort to Inflate Tangible Asset Values in Sales.

When an operator buys a system, the asset value is typically written up. The Commission should not allow operators to so inflate the value of the tangible assets, with perhaps one exception: where the operator shows that the additional asset value is fully offset by savings realized by consumers (through reduced operating costs, for example). Unless it takes such an approach, the FCC will create an incentive for operators to sell systems merely to increase rate base -- and hence available returns.

3. The FCC May Have Underestimated the Difficulty of Valuing Plant Attributable to Regulated Services.

The problems associated with identifying the rate base attributable to regulated services does not end with the exclusion of intangibles and excess acquisition costs. Cable systems are not being upgraded now primarily to enhance basic and expanded basic services, but instead are being improved to allow cable companies to offer pay-per-view movies on demand and to offer nontraditional cable services. Excess, unactivated capacity is being installed, and in many cases, fundamental system design (and costs) are being driven by the industry's efforts to position itself to provide these advanced services. For example, the cable industry has been testing regional hubs in several parts of the country, including King County. The regional hubs are designed to serve as the platform for, inter alia, "mass storage for multi-channel pay-per-view," "PCS switching and cross-connecting facilities," "multimedia distribution," "advanced television," "advertising insertion" and "bulk program distribution." Specs Technology, Cable Television Laboratories, February/March 1993 at p. 1. It is not that the Coalition opposes these developments; by and large, it supports them. However, the FCC's proposed rules do not adequately address the rate-setting problems created by the transformation of cable from a television delivery system to a multi-service delivery system. For example, it is not clear how the Commission intends to treat investment associated with upgrades primarily undertaken to provide nontraditional cable services. The Commission should make it clear that under the used and useful test, a cable company will not be allowed to inflate the investment attributable to basic and expanded basic cable service and equipment when it upgrades the system unless, for example, it can also show that the rebuild substantially benefitted subscribers to the regulated services and that costs allocated to those subscribers do not exceed the cost of alternatives.

Unregulated services should not be allowed to obtain a free ride on the back of regulated services through an improper allocation of investment costs.

Further, the Commission may need to clarify how much of the total investment in the system to attribute to capacity that is installed but not activated, or that is activated to provide nontraditional cable services. If the cost of system capacity allocated to unregulated services is valued only at the marginal cost of installing that capacity, above and beyond the cost of installing a smaller capacity system capable of providing the regulated services, subscribers to regulated services will effectively subsidize the development of unregulated services. What is more, there will not be a clear way to correct for this subsidization in the future. Under the Commission's cable regulatory scheme, once investment is allocated to regulated services (and rates set) there is no mechanism that would force operators to revisit that allocation, no matter how the operator's business changes, because it is up to the operator alone to initiate cost of service proceedings. The Commission must devise a clear mechanism for avoiding the anticompetitive problems inherent in such subsidization.[9]

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[9] There may be different approaches possible. For example, the problem could be addressed in the initial allocation of costs, or by requiring that some form of revenue credits be returned to subscribers over time as new services develop.

4. The Commission Should Not Assume the Cable Industry Has a Positive Working Capital Requirement.

Because the cable industry bills for services in advance of providing them, there is significant reason to suppose that the cable industry has a negative working capital requirement. To protect consumers, an operator that submits a cost of service filing should be required to submit a lead-lag study to establish working capital requirements. Such studies are relatively simple to perform, and the requirement should result in substantial benefits to consumers.

C. Rate of Return

The Coalition supports establishment of at least a national cost of equity for cable companies, but the Commission's suggested approach would provide operators a return on regulated services far in excess of the return required to attract investors. The Shew Report estimated that the after-tax cost of capital for TCI was 7.26% in 1978 when, if anything, the cable industry was riskier than it is today. Shew Report, App. A, at 8-9. That return is almost 50% lower than the return proposed by the FCC.

The Commission's analysis would show that a far lower return is required if its formula incorporated a more realistic debt-to-equity ratio. The cable industry has always been heavily leveraged. Standard & Poor's Industry Surveys for February 1993 estimated that 80% of TCI's capital was debt; Comcast's debt was

87% of capital, and at the low end, TCA Cable TV's debt was 62% of its capital.[10]

In addition, the Commission's analysis should recognize that the business of providing basic and expanded basic services is not particularly risky, and at this point is far more akin to providing local telephone service than it is to providing the sorts of services provided by the Standard & Poor 400. Indeed, telco returns -- now at 11.25% -- assume about a 70% mix of higher cost equity capital, suggesting that even those returns may be more than is required to allow the cable industry to attract investors.

III. STREAMLINING REGULATION

A. Generally

The Commission asks whether it should "streamline" regulation by allowing operators to use a variety of possible methods short of making a full cost of service showing to justify a rate above the benchmark. The answer, generally, is: it should not. As proposed by the Commission, all that such shortcuts would do is allow operators to pick and choose among regulatory schemes -- with the predictable result that rates will remain high. Particularly objectionable are proposals that would allow operators to justify higher rates based on the fact that some of their costs are higher than costs the Commission

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[10] The Commission should not base calculation of debt-to-equity ratios on the market value embedded capital.

determines are critical to the calculation of the benchmark. Such an approach would result in cost-shifting, as companies seek to transfer expenses to those critical categories that will be examined and out of categories that will be effectively hidden from review. Offsetting factors which, collectively, may more than compensate for the added expense in a particular area would be ignored. The scheme is not likely to lead to reasonable rates, or to significantly reduce regulatory costs.

B. Small Systems

The Commission asks whether it should adopt a streamlined method for small systems even if it does not adopt one for larger systems. The Commission should not allow any operator, large or small, to pick and choose among regulatory schemes. The benchmark already benefits small operators by giving them substantially higher rates per channel than are available to operators of larger systems. There will be few cases where small operators must rely on a cost of service proceeding to justify a rate. In those few cases where a cost of service is required, nothing in the Commission's rules require that proceeding to be complicated, as long as the operator keeps reasonable books and records. Because the rules allow operators to seek relief at this Commission -- including asking the Commission to decertify a franchising authority that the operator believes is abusing its power -- the only case where the proceeding is likely to be complicated is where the operator proposes a rate so high that it is worth the cost to the community to investigate it. It is precisely in those cases, however, that the rate must be fully justified.

C. Equipment Charges

It may make sense to streamline the benchmark by developing national or regional equipment and installation cost averages. The calculation of the equipment basket is the most complicated aspect of the Commission's regulations. Given the way equipment costs are removed in the process of calculating the operator's maximum permitted charge per channel, and the fact that the equipment costs are relatively distinct costs, using reasonable averages should not distort overall benchmark results. However, in an individual cost of service proceeding, where an operator's costs are broadly examined, it is far less necessary and makes far less sense to use an average as a proxy for actual equipment costs.

IV. PRODUCTIVITY INDEXING

The Coalition strongly supports adoption of a productivity index. As a number of commentators have pointed out, the United States is seeing a merger of the television, computer and telephone industries. The cable industry has positioned itself to take advantage of that merger through transactions with major software and hardware vendors and is continuing to do so. As a result of these actions, the cable industry will directly benefit from, and can be expected to share in productivity increases in, the telecommunications and computer industries. A substantial and meaningful productivity index is therefore necessary to protect consumers.

Respectfully submitted,

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